

Decision **PROPOSED DECISION OF ALJ WALKER** (Mailed 12/19/2003)**BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA**

In the Matter of the Application of Southern California Water Company (U 133 W) for an Order pursuant to Public Utilities Code Section 851 Approving a Settlement Agreement that will convey Water Rights in the Culver City Customer Service Area.

Application 02-07-021
(Filed July 11, 2002)

Patricia A. Schmiede, Attorney at Law, and
Susan L. Conway, for Southern California Water Company, applicant.

Joseph Lawrence, Attorney at Law, and Nossaman,
Guthner, Knox & Elliott, LLP, by Martin Mattes,
Attorney at Law, for the City of Santa Monica,
Interested party.

James E. Scarff, Attorney at Law, and Sung Han, for the
Office of Ratepayer Advocates.

OPINION RESOLVING RATEMAKING ISSUES**1. Summary**

In Interim Decision (D.) 03-05-001 on May 8, 2003, the Commission approved a settlement between the City of Santa Monica (City) and Southern California Water Company (SCWC) that conveyed SCWC water rights to the City and relieved SCWC from its participation in a number of pending lawsuits related to the Charnock Groundwater Basin (Charnock Basin, or the Basin). The issue of ratemaking treatment of the settlement proceeds and the issue of

contamination payments made to SCWC by oil companies were deferred to this phase of the proceeding. This decision resolves those issues. The application is closed.

2. Background

Since 1928 and until 1996, SCWC relied on groundwater pumped from the Charnock Basin for a portion of its water supply for its customer service area in Culver City, located in western Los Angeles County. In 1996, the Basin's groundwater was found to be contaminated with MTBE, a gasoline additive. The City, which had pumped a far greater water supply from the Basin, and SCWC filed lawsuits against oil companies and gasoline station owners and operators (Potentially Responsible Parties, or PRPs). In an interim settlement agreement, the PRPs in 1998 agreed to make payments to the City and to SCWC for the loss of Basin water. In 1999, the PRPs disavowed the agreement but in the same year were ordered by the Environmental Protection Agency (EPA) and the Regional Water Quality Control Board to continue making payments on a lesser scale. Meanwhile, SCWC and the City disputed each other's rights to pump groundwater from the Basin and eventually sued each other over those rights.

Under the settlement between SCWC and the City approved by the Commission in D.03-05-001, SCWC (1) will exchange its claim to groundwater rights in the Basin for a payment equal to the fair market value of 1,050 acre-feet of groundwater rights, and (2) will receive payment equal to the fair market value of its wells and most of its other water production facilities in the Basin. In addition, the City assumes all liability for any claims the PRPs have against SCWC for overpayments made under their interim settlement agreement, and SCWC assigns to the City its rights under the SCWC contamination lawsuit against the PRPs. SCWC expects to receive approximately \$5.9 million in net

settlement proceeds from the City. SCWC also avoids the costs and risks of its lawsuits against the PRPs and the City.

SCWC argues that the net settlement proceeds from the City's payment are governed by Pub. Util. Code § 790, which requires that money from the sale of unneeded water company assets be invested in the utility's infrastructure and that the infrastructure improvements then be added to rate base. SCWC argues that net proceeds of some \$5 million being paid by the PRPs directly to SCWC should accrue to shareholders because the payments are for damage to the utility's water rights, which are a shareholder asset to which ratepayers have contributed nothing.

These proposals are opposed by the Office of Ratepayer Advocates (ORA). ORA argues that Pub. Util. Code § 790 does not apply to the City's purchase of various rights and causes of action transferred by SCWC, and all or at least a substantial part of the net proceeds should be booked in a manner that benefits ratepayers. As to the \$5 million in payments made by the PRPs, ORA argues that this is money that SCWC already has recovered in rates for the higher cost of water purchased from the Metropolitan Water District (MWD) to replace the contaminated Basin water. Accordingly, ORA would book this money to the utility's purchased water balancing account for a refund to ratepayers when the balancing account is zeroed out in March of each year.

3. Procedural Background

As directed by D.03-05-001, SCWC on June 6, 2003, filed a report on its proposed treatment of the net settlement proceeds from the City. SCWC states that the approximately \$5.9 million in net proceeds will be invested in the 10 most critical capital projects facing the utility, including substantial water main replacement, construction of a new reservoir, and construction of new

wells, and that these facilities will be added to rate base when they are put into service.

ORA on June 17, 2003, responded to SCWC's report, arguing that net proceeds from the settlement with the City should be invested in infrastructure but booked as contributions to capital. Contributions are not eligible for addition to rate base and are not eligible for a rate of return. ORA also repeated its call to have net proceeds received from the PRPs debited to SCWC's purchased water balancing account for later refund to ratepayers.

Following these filings, a Prehearing Conference was conducted on October 29, 2003, attended by SCWC and ORA, the only active parties in this phase of the proceeding. (The City is not taking part in the ratemaking phase of this application.) SCWC and ORA agreed that this phase would deal only with the ratemaking aspects of monies that SCWC is or will be receiving from the City and from the PRPs. The parties also agreed that no further hearings were necessary because they had presented their evidence on ratemaking at the evidentiary hearing on March 4, 2003, and because both SCWC and ORA had extensively briefed these issues.

ORA introduced two documents – the interim SCWC settlement with PRPs and the EPA order requiring continued payments – and these documents were received into evidence without objection. SCWC asked for and was granted the opportunity to reply to ORA's June 17 filing. The date for SCWC's reply was November 26, 2003, at which time this phase of the proceeding was deemed submitted for decision.

4. Ratemaking Treatment of Proceeds Received From the City

The settlement proceeds that the City will pay to SCWC in exchange for the conveyance of SCWC's Charnock Basin water rights are comprised of two components. The first component is the value of 1,050 acre-feet of groundwater rights, estimated to be \$3,675,000. The second settlement component is the value of Charnock Basin wellfield facilities (excluding the underlying real property). The parties are to obtain and exchange fair market value appraisals of these facilities and then seek to negotiate a mutually agreeable settlement value, or submit the valuation issue to binding arbitration. SCWC's appraisal of the facilities to be purchased is \$2,750,000.

Both the payment for SCWC's water rights and the payment for the Charnock Basin facilities are to be made at the earlier of five years from the settlement date (by March 2007), or within a set time after the City obtains a final judgment or settlement of its contamination lawsuit against the PRPs.¹

SCWC states that it will remove the book value of Charnock Basin facilities from rate base. The net book value of approximately 40 line items to be removed from rate base was \$523,671 as of March 2003. SCWC expects to deduct the then-current net book value of these assets from the settlement proceeds, resulting in estimated net proceeds from the settlement of \$5,901,329.²

¹ Newspaper reports on November 22, 2003, indicated that settlement had been reached between the City and three oil companies. The settlement requires court approval.

² SCWC expects the total proceeds from its settlement with the City to be approximately \$6,425,000, with an estimated \$3,675,000 from the sale of groundwater rights and an estimated \$2,750,000 from the sale of wellfield facilities. The book value of approximately 40 items to be removed from rate base would be \$523,671. (*See Ex. 9.*)

Footnote continued on next page

4.1 Positions of the Parties

SCWC contends that its Basin water rights and facilities will at the time of sale no longer be necessary or useful because of the MTBE contamination and that, therefore, the estimated \$5.9 million in net proceeds that it will receive from the City must be governed by the Water Utility Infrastructure Improvement Act, codified at Pub. Util. Code §§ 789-790.1. In pertinent part, § 790 provides:

790. (a) Whenever a water corporation sells any real property that was at any time, but is no longer, necessary or useful in the performance of the water corporation's duties to the public, the water corporation shall invest the net proceeds, if any, including interest at the rate that the commission prescribes for memorandum accounts, from the sale in water system infrastructure, plant, facilities, and properties that are necessary or useful in the performance of its duties to the public. For purposes of tracking the net proceeds and their investment, the water corporation shall maintain records necessary to document the investment of the net proceeds pursuant to this article. The amount of the net proceeds shall be a water corporation's primary source of capital for investment in utility infrastructure, plant, facilities, and properties that are necessary or useful in the performance of the water corporation's duties in providing water utility service to the public.

(b) All water utility infrastructure, plant, facilities, and properties constructed or acquired by, and used and useful to, a water corporation by investment pursuant to subdivision (a) shall be included among the water corporation's other utility property upon which the

Thus, SCWC's current best estimate of the net settlement proceeds that will be available to be reinvested in Region II systems is \$5,901,329.

commission authorizes the water corporation the opportunity to earn a reasonable return.

(c) This article shall apply to the investment of the net proceeds referred to in subdivision (a) for a period of 8 years from the end of the calendar year in which the water corporation receives the net proceeds. The balance of any net proceeds and interest thereon that is not invested after the eight-year period shall be allocated solely to ratepayers.

SCWC contends that its water rights in the Basin are a form of real property, citing *Smith v. Municipal Court* (1988) 202 Cal.App.3d 685, 689 [“[w]ater in its natural state is a part of the land, and therefore real property”] and 62 Cal.Jur.3d *Water* § 1, p. 25 (3d ed. 2000) [“Water in its natural state...is part of the land, to be considered as real property”]. According to SCWC, its water rights in the Charnock Basin are fully vested real property rights, the sale of which triggers the requirements of § 790.

SCWC has submitted a list of 10 infrastructure projects that it intends to finance through the sale proceeds, but it notes that since the amount and timing of the settlement payment from the City is unknown at this time, the list of projects may change when the proceeds are actually received.

ORA’s witness testified at hearing that SCWC’s Basin facilities are currently in rate base (and thus, by definition, remain necessary or useful in utility operation), and that after cleanup Charnock Basin groundwater could be used in the future as a source of lower cost water. Under this reasoning, § 790 would not apply to all or part of the transaction with the City, and the Commission would be free to find that proceeds of the sale should go to ratepayers as a rebate. On brief, ORA maintains that even if § 790 applies, the Commission may book proceeds of the sale at zero dollars for ratemaking

purposes, with any investment of proceeds treated as contributions to capital rather than new shareholder investments.

ORA cites the Commission decision in *Re Great Oaks Water Company* (1993) 51 CPUC2d 366. There, the Commission approved a settlement between a water company and the Commission advocacy branch in which \$3.2 million in contamination settlement funds was booked to a memorandum account for infrastructure improvements, with 50% treated as contributions and 50% added to rate base. The Commission commented at the time that the ratemaking treatment of excess contamination payments was one of first impression, and that no statutory provision at that time governed disposition of such funds.

4.2 Discussion of City Settlement Proceeds

Testimony shows that SCWC has relied solely on purchased water for the Culver City system for several years. In the early 1990s, SCWC began investing in and upgrading its Basin groundwater production facilities. By 1994, SCWC had refurbished its two Basin groundwater wells and constructed a wellhead treatment system to remove impurities from the groundwater and make greater use of that water in SCWC's water mix. Before those facilities could be used in a meaningful way, however, the MTBE contamination was discovered in 1996 and all groundwater production from the Basin was terminated.

SCWC's water quality expert testified that MTBE is especially problematic because once introduced it is highly water-soluble and spreads rapidly through the water supply. MTBE is considered a potential human carcinogen when ingested. The expert testified, without contradiction, that eliminating the MTBE and restoring Basin water to potable standards may never occur or, at best, is likely to be many years away.

Under these circumstances, it is clear that SCWC's water rights and most of its facilities in the Basin are no longer necessary or useful in the provision of water service and have not as a practical matter been useful since 1996. It is equally clear that an established principle of California law is that water in its natural state is a part of land and therefore constitutes real property. (*See, e.g., Stanislaus Water Co. v. Bachman* (1908) 152 Cal. 716, 725.)

It follows that the sale of the water rights and ancillary equipment is governed by Pub. Util. Code § 790 since that statute governs the sale by a water company of real property that once was but is no longer necessary or useful in the company's service to its customers. In § 789.1, the Legislature stated its intent to encourage water companies to sell unneeded real property to help deal "with increasing demands for new infrastructure, plant, and facilities to comply with increasingly strict state and federal safe drinking water laws and regulations." (§ 789.1(a).)

ORA contends that the City's payment for assignment of SCWC's cause of action against the PRPs does not qualify for § 790 treatment since a cause of action is not real property. We find on this record that the assignment of SCWC's damage claims is part and parcel of the sale of SCWC's water rights, since SCWC cannot transfer its water rights to the City and at the same time retain the ability to recover from the PRPs for damages to those water rights.

This Commission recently analyzed § 790 at length in *Re California Water Service Company* (2003) D.03-09-021. We concluded that:

...§ 790 requires water utilities to sell no longer needed property and to invest the net proceeds in needed infrastructure. These net proceeds are to be the utility's primary source of capital for infrastructure, and the utility must track the investment of the proceeds. The utility has

eight years to re-invest the funds, and must include the property among its other utility property [for ratemaking purposes]. (D.03-09-021, at 65.)

SCWC's financial witness testified that the sale proceeds will help pay for much needed new facilities to serve Culver City customers. He stated that customers also will benefit by not having to fund fees and interest on new loans or equity investment that otherwise would be required to accomplish the infrastructure improvements.

Following the guidance provided in D.03-09-021, our order today requires SCWC to (1) book net settlement proceeds as received from the City into an interest-bearing memorandum account; (2) use the memorandum account fund as SCWC's primary source of capital for investment in utility infrastructure; (3) invest all net proceeds recorded in the memorandum account in infrastructure improvements within eight years of the calendar year in which the proceeds were received, (4) maintain records of all memorandum fund activity for inspection by the Commission, and (5) obtain the Commission's approval to include the infrastructure improvements in rate base as the improvements become necessary and useful.

5. Ratemaking Treatment of PRP Payments

After the discovery of MTBE in the Charnock Basin groundwater, the City and SCWC independently began negotiating with the PRPs to obtain compensation for the loss of use of the Basin. Both the City and SCWC negotiated temporary settlement agreements with some of the oil company PRPs in 1998. In 1999, the oil companies terminated the agreements, contending in SCWC's case that it held no meaningful groundwater rights in the Basin and was entitled to little or no reimbursement for the loss of Basin water.

In anticipation of the termination of the interim settlement agreements, the EPA issued an administrative order against one of the PRPs to continue paying the City and SCWC for the loss of use of Basin groundwater. Under the EPA order, SCWC received compensation for the loss of use of 577 acre-feet per year of Basin groundwater. The 577 acre-feet represented SCWC's use of groundwater in 1995, the last full year of groundwater pumping in the Basin.

Since 1998, SCWC has collected approximately \$5 million from the PRPs. Under the EPA order, SCWC continues to receive \$21,974 per month from the PRPs, and these payments are to extend to the year 2005.

SCWC has booked \$4.2 million of these payments as a credit in its Account 704, which records costs for purchased water. Approximately \$800,000 has been booked to Account 798 for legal expenses that SCWC incurred in its contamination and water rights litigation. The PRP payments are not reflected in SCWC's rate base and were not addressed its most recent general rate case for the Culver City region in 1998.

5.1 Positions of the Parties

SCWC maintains that the PRP payments were designed to compensate for damage done to SCWC's water rights, and therefore the money should be retained by SCWC and not shared with ratepayers. SCWC's financial witness stated that SCWC has borne the cost of acquiring, maintaining and defending its Charnock Basin water rights, and ratepayers have contributed nothing toward those efforts. He stated that Basin water rights have never been included in rate base, that ratepayers have paid nothing toward the remediation of the MTBE contamination, and that SCWC has paid all of the costs associated with the water rights and MTBE lawsuits.

On brief, SCWC argues that ratepayers should be indifferent to the PRP payments since they have no effect on rates. SCWC asserts that ratepayers have incurred no added costs because SCWC's last two rate cases for the Culver City district relied entirely on purchased water and included no mix of groundwater. SCWC cites *Great Oaks Water Co.* (1993) 49 CPUC2d 116 for the proposition that allocating settlement payments to ratepayers in such circumstances is inappropriate because doing so "would place them in [a] better position than if the contamination had not occurred." (49 PUC2d at 123.)

ORA's witness testified that since 1996 SCWC ratepayers have been paying more for purchased water than would otherwise have been required had Basin groundwater been available. He stated that ratepayers also have been paying depreciation and a rate of return on the refurbished wells and other facilities at the Basin that would have increased the use of pumped water but now cannot be used because of the contamination. On brief, ORA argues that allowing SCWC to retain the money it receives from the PRPs is a "windfall" for shareholders, since the increased costs for purchased water have already been recovered in rates.

ORA urges that the Commission direct that the net proceeds from the PRP payments be transferred from Account 704 (purchased water) to Account 704.02 (purchased water balancing account). When the balancing account is netted out in March of each year, the amount in excess of that actually spent on purchased water would be refunded to ratepayers. ORA states that SCWC should be permitted to retain PRP proceeds sufficient to cover legal and other expenses that SCWC has paid in dealing with PRP issues and litigation.

5.2 Discussion of Ratemaking Treatment of PRP Proceeds

There is little precedent in Commission decisions for dealing with the ratemaking treatment of damage awards in contamination lawsuits and settlements. The Commission has approached the issue on a case-by-case basis, with the facts of each case determining the result.

Thus, in *Re Great Oaks Water Company* (1993) 49 CPUC2d 116, we remanded for further hearing the issue of how to deal with \$2.3 million in contamination proceeds that were not needed to clean up contamination. We commented then:

The company was willing to have the entire \$2.5 million [of the contamination award] treated as a contribution (and not included in rate base) if it was spent to remedy contamination. Thus, on the one hand, we can envision an equitable argument, or one based on Civ. Code § 1882.6 [authorizing the Commission to take excess damage awards into account in setting rates], that any surplus should benefit ratepayers, either as a contribution or in some other manner. On the other hand, we also can see an argument that this money represents damages to the corporation, a legal entity, and the corporation should be free within reasonable bounds to treat the funds as it desires. (49 CPUC2d at 123.)

On remand, the parties in *Great Oaks* reached a settlement agreement in something of a precursor to Pub. Util. Code § 790. The parties agreed that the contamination proceeds would be booked to a memorandum account for investment in utility infrastructure, with 50% deemed a contribution not affecting rates or rate base and 50% treated as additions to rate base. (*Re Great Oaks Water Company* (1993) 51 CPUC2d 366.)

In *Re Del Este Water Company* (1995) 60 CPUC2d 418, we stated the general principle “that the Commission, when dealing with contamination

settlements or awards, generally seeks first to make ratepayers whole for amounts that they have paid in rates because of contamination.” (60 CPUC2d at 423.) However, we noted that the principle applied only when contamination proceeds exceeded the cost of correcting the contamination. In *Del Este*, the evidence showed that contamination cleanup costs were likely to far exceed litigation proceeds, and the Commission allowed the proceeds to be retained by the company for that purpose.

Interestingly, SCWC was a major player in the seminal and somewhat analogous case dealing with disposition of the gain on sale of the utility’s headquarters. In *Re Southern California Water Company* (1992) 43 CPUC2d 596, the Commission articulated the theory of the “enduring enterprise” as the principle by which it would examine gain on sale for cases with a similar fact situation. There, SCWC recorded a \$1.2 million gain in the sale of its former general office building. In declining to follow earlier “ratepayer indifference” and “risk-sharing” theories set forth in *Re Southern California Gas Company* (1990) 36 CPUC2d 235, *modified on rehearing*, 38 CPUC2d 166, the Commission declined to award the gain directly either to shareholders or ratepayers. Instead, it ordered SCWC to retain the gain in the utility’s operation but apply it to reduce the utility’s rate base, stating:

Ratepayers will benefit over the long term through a reduction in rate base by the amount of the gain-on-sale and the consequent reduction in the return on the reduced rate base. By not using the gain-on-sale as a direct offset against the utility’s revenue requirement, but rather as a reduction to rate base, the gain-on-sale will remain in the utility’s operation. As such, the gain-on-sale will accrue to the benefit of shareholders in the future if and when the utility’s operations are liquidated and its obligation to serve is dismissed. (43 CPUC2d at 604.)

The facts of the case before us differ from the facts in these earlier cases. Here, SCWC has received some \$5 million from PRPs for damage to an asset (its right to use the Basin groundwater) that SCWC is transferring to the City. Unlike Del Este Water Company, SCWC faces no further costs of cleanup of the Basin supply. Unlike the gain-on-sale case involving its headquarters, SCWC is not replacing one asset (former headquarters) with another equivalent asset (new headquarters).

Moreover, SCWC within five years stands to receive \$5.9 million or more in net proceeds in the sale of its Basin groundwater rights and facilities to the City. The settlement agreement with the City removes a risk that part of the money obtained from PRPs might have to be refunded because the City agreed to indemnify SCWC against PRP claims of over-payment under an initial settlement agreement.

If the PRP payments stood alone, without the sale of the Charnock rights to the City, our assessment of how to deal with the contamination proceeds would take a different direction. First, we would have to quantify the likely additional costs that SCWC would face in seeking to clean and reopen the Basin supply. We also would have to deal with the several millions of dollars the record shows would be spent on attorney and consultant fees for the contamination and the water rights lawsuits. As we did in the *Great Oaks* case, we would give more weight to the argument that this money compensates the company for damage to an asset, and the company should be free within reasonable bounds to use the money to remedy the damage.

That is not the case here. It is difficult to assess any damage to SCWC's Basin rights and assets that will not be ameliorated by the sale to the City. The higher cost of purchased water to replace Basin water has been borne by

ratepayers in the past two general rate cases and likely will continue to be borne for the foreseeable future. The \$5.9 million sale price to the City will be used pursuant to § 790 to repair and replace infrastructure upon which ratepayers will pay depreciation and a rate of return. Ratepayers have, until now, paid depreciation and a rate of return on the Basin wells and treatment facilities that have been useless since 1996.

While many of the cost estimates in this case were filed under seal because of the pending lawsuits, one can discern from the public settlement awards and estimates that ratepayers since 1996 have paid millions of dollars in rates because of the loss of Basin groundwater. So long as the district must rely solely on purchased MWD water, rates will continue to be higher than they would be if uncontaminated groundwater were available to add to the water mix.

Under these circumstances, we believe that our task under the principles set forth in *Great Oaks* and *Del Este* is to seek to make ratepayers whole for the amounts that they have paid (and will continue to pay) in rates because of the MTBE contamination. SCWC argues that ratepayers have incurred no costs because their last two rate cases relied entirely on purchased water and included no mix of groundwater. There is no question, however, that had uncontaminated Basin water been available, SCWC had made substantial investments in facilities and was prepared to continue using Basin water. SCWC's tariffs witness acknowledged that pumped water is less costly than water purchased from MWD, and he testified that historically Culver City has been served with a mix of about 35% pumped water (from Charnock Basin and other basins) and 65% purchased water.

Finally, as pointed out by ORA, SCWC's interim settlement agreement with the PRPs and the later EPA order requiring PRP payments are intended to reimburse SCWC for the costs (primarily of purchased water) it would not have incurred but for the MTBE. Indeed, the EPA order directs PRPs to provide SCWC with 577 acre-feet of "water replacement" per year for a period of five years beginning on January 7, 2000. Alternatively, PRPs are permitted to make "water replacement payments" in lieu of water replacement. (EPA Order 99-085, Attachment A, p. 3.) Had PRPs elected to deliver 577 acre-feet of water to SCWC instead of money, the water would have been added to SCWC's mix and rates would have reflected a substantial decrease in the cost of purchased water.

Under these circumstances, we agree with ORA that PRP payments, less SCWC's legal and other expenses related to the litigation that resulted in the PRP settlement and EPA order, should go to ratepayers to reimburse them for the higher rates they have paid and will continue to pay because of the MTBE contamination of the groundwater. While the rules governing the purchased water balancing Account 704.02 do not normally permit a utility to add contamination payments to that account, our order today makes an exception to those rules and directs SCWC to transfer those contamination payments from Account 704 to Account 704.02, for eventual refund to ratepayers. SCWC is to continue booking such payments to Account 704.02 while such payments continue.

6. Removal of Basin Facilities From Rate Base

Initially, SCWC proposed to keep its Basin wells and other facilities in rate base until formal transfer of those assets to the City. Ratepayers would continue to pay depreciation and a rate of return on the facilities for up to five years. ORA

objected, arguing that the facilities obviously are no longer necessary or useful for SCWC's service to its customers.

SCWC's tariffs expert agreed at hearing that the facilities being transferred to the City should be removed from rate base once the agreement with the City became final. At the conference on October 29, 2003, counsel for SCWC stated that the Commission's approval of the transfer of facilities in D.03-05-001 substantially finalizes the settlement and permits the removal of Basin facilities from rate base. SCWC has already taken steps in its current general rate case for the region (Application 03-10-006) to remove the Basin facilities from rate base.

In view of SCWC's commitment to remove the relevant assets from rate base, and without ORA objection, this issue is resolved.

7. Comments on Proposed Decision

The proposed decision of the Administrative Law Judge (ALJ) for the current phase of this matter was mailed to the parties in accordance with Pub. Util. Code § 311(d) and Rule 77.1 of the Rules of Practice and Procedure. In its comments, SCWC argues that the PRP payments (less the company's litigation expenses) should not be refunded to ratepayers because SCWC probably could not have prevailed in its claim for water rights in the Charnock Basin. SCWC asserts that if the City had successfully shown that its Basin water rights were superior to those of SCWC (because of earlier and substantially greater use by the City), SCWC probably would not have been permitted to pump from the Basin, and ratepayers still would have had to pay for purchased water instead of pumped water. SCWC argues that even if it had prevailed, the availability of pumped water would have applied only to the rate case years beginning in 1999 and would not have amounted to more than \$750,000 in savings for ratepayers.

ORA responds that neither the record nor SCWC's previous pleadings support an argument that SCWC's rights to Basin water were worthless. It notes that the City agreed to pay SCWC some \$3.675 million as the fair market value of 1,050 acre-feet of uncontaminated Basin water to which SCWC claimed a right, plus \$2.75 million for the diminished value of SCWC's Charnock wellfield plant (which could only have value if SCWC had Basin water rights). Moreover, ORA asserts, the City agreed to indemnify SCWC against repayment of \$5 million that SCWC had received from PRPs, a risk that the City would not have taken unless it concluded that SCWC could demonstrate its water rights. ORA argues that the \$750,000 cap on ratepayer damages proposed by SCWC is inconsistent with SCWC's earlier claims that a far greater amount of Charnock water would have been available for a far longer period of time absent the pollution.

We agree with ORA that SCWC's unusual assertion that its claims to Charnock water rights (which it was spending millions of dollars to defend) were unlikely to succeed. SCWC had been tapping Basin water for some 65 years, and it had recently made substantial investments in its Charnock wellfield plant to continue and increase its pumping. SCWC had pumped 577 acre-feet from the Basin in 1995, and the record supports a conclusion that pumping at that or greater levels would have continued in 1996 and later years but for the pollution. The settlement amounts agreed to by the City and ordered by the EPA estimate several millions of dollars that were spent by SCWC (and recovered in rates from ratepayers) because of the unavailability of pumped water. We reject SCWC's conclusory arguments to the contrary.

At the request of SCWC, we will clarify that SCWC may recover from the PRP payments all of its current and pending litigation and consultant costs and fees (estimated at time of hearing at \$800,000) incurred in connection with both

the lawsuit against the City and the lawsuit against the PRPs. ORA agrees that recovery of litigation costs from PRP payments is appropriate in this case.

ORA in its comments focuses on the City's settlement with SCWC. ORA repeats its arguments that SCWC has failed to show that its Charnock water rights were no longer necessary or useful, and therefore were not subject to Pub. Util. Code § 790, which requires that a water company's sale of real property that is no longer necessary or useful be reinvested in infrastructure within eight years. ORA also argues that the portion of the City's payment that pertains to plant and infrastructure at SCWC's Charnock wellfield did not represent a true sale, in that title to the facilities did not change hands.

SCWC responds that the City's payment under the settlement agreement relates entirely to the sale of SCWC's rights to water in the Charnock Basin, and water rights constitute real property under California law. The amount of payment was established by proxy to be equal to the fair market value of SCWC's right to pump from the basin and the value of water production facilities in the Basin. SCWC asserts that neither portion of the payment can be conceptually separated from the rest of the settlement for ratemaking purposes.

We agree with SCWC that the proceeds from the settlement with the City are for SCWC's water rights, which are deemed to be real property, and thus subject to Pub. Util. Code § 790. Attempts to distinguish the proxy elements in computing the amount of the sale are unavailing, since those elements are all part and parcel of the agreed price for the transfer of the water rights. The evidence also shows that SCWC's Basin water rights were not necessary or useful at the time of sale because the water was polluted. ORA cites our decision in *Re California Water Service Company* (2003) D.03-09-021, as somehow contradictory to the decision reached here. We disagree. In that case, we found against the

position of the water company that, under Section 790, it could pass the proceeds from the sale of a service center directly to shareholders as long as it eventually invested an equivalent amount of money in new infrastructure. That is not what SCWC sought here, nor is it what our decision today instructs SCWC to do.

Accordingly, for the reasons set forth here and in the text of the decision, we decline to depart from the findings of the proposed decision of the ALJ.

8. Assignment of Proceeding

Susan P. Kennedy is the Assigned Commissioner in this proceeding. The assigned ALJ for the current phase of this proceeding is Glen Walker.

Findings of Fact

1. The Commission in D.03-05-001 approved a settlement between the City and SCWC that, among other things, conveyed SCWC's water rights in the Charnock Basin to the City.

2. The City is to pay approximately \$5.9 million to SCWC for conveyance of the water rights and SCWC wells and other facilities at the Charnock Basin.

3. Ratemaking treatment of the City's payment to SCWC and ratemaking treatment of PRP payments to SCWC were deferred to this phase of the proceeding.

4. Since 1928 and until 1996, SCWC relied on groundwater pumped from the Charnock Basin for a portion of its water supply for its Culver City customer service area.

5. In 1996, the Charnock Basin groundwater was found to be contaminated with the gasoline additive MTBE.

6. The City and SCWC filed lawsuits against various oil companies and other PRPs.

7. PRPs in interim settlement agreements in 1998 agreed to make payments to the City and SCWC for the loss of Basin water.

8. PRPs in 1999 disavowed the settlement agreements and refused to make further payments to the City and to SCWC.

9. An EPA order in 1999 required one or more PRPs to provide water replacement or water replacement payments to the City and to SCWC.

10. SCWC has received approximately \$5 million in PRP payments, and monthly payments of \$21,974 are to continue until the year 2005.

11. SCWC has booked approximately \$4.2 million of PRP payments to its Account 704 (purchased water) and approximately \$800,000 to its Account 798 (legal expenses).

12. In its last two general rate cases for the Culver City service area, SCWC has provided only for water purchased from MWD and has included no groundwater in its supply.

13. Historically, pumped water from Charnock Basin has cost less than purchased water.

Conclusions of Law

1. SCWC's water rights in the Charnock Basin are a form of real property.

2. Pub. Util. Code § 790 governs the disposition of net proceeds that a public water utility receives from the sale of real property that was at any time but is no longer necessary or useful in the performance of the utility's duties to the public.

3. Pub. Util. Code § 790 applies to the sale by SCWC of its water rights and related facilities in Charnock Basin.

4. SCWC should be directed to (a) book net settlement proceeds as received from the City into an interest-bearing memorandum account; (b) use the memorandum account fund as SCWC's primary source of capital for investment

in utility infrastructure; (c) invest all net proceeds recorded in the memorandum account in infrastructure improvements within eight years of the calendar year in which the proceeds were received, (d) maintain records of all memorandum fund activity for inspection by the Commission, and (e) obtain the Commission's approval to include the infrastructure improvements in rate base as the improvements become necessary and useful.

5. The Commission deals with ratemaking treatment of damage awards in contamination lawsuits and settlements on a case-by-case basis.

6. As a general principle, the Commission in dealing with contamination settlements or awards generally seeks first to make ratepayers whole for amounts that they have paid in rates because of contamination.

7. SCWC ratepayers have since 1996 paid water rates higher than the rates would have been had unpolluted water from Charnock Basin been available to supplement water purchased from the MWD.

8. SCWC should be directed to transfer net proceeds of the PRP payments at issue from Account 704 (purchased water) to Account 704.02 (purchased water balancing account) for refund to ratepayers.

O R D E R

IT IS ORDERED that:

1. Southern California Water Company (SCWC) is directed to deal with settlement payments received from the City of Santa Monica (City), for conveyance of SCWC's Charnock Groundwater Basin assets, in the manner set forth in Pub. Util. Code § 790.

2. SCWC shall (a) book net settlement proceeds as received from the City into an interest-bearing memorandum account; (b) use the memorandum account

fund as SCWC's primary source of capital for investment in utility infrastructure; (c) invest all net proceeds recorded in the memorandum account in infrastructure improvements within eight years of the calendar year in which the proceeds were received, (d) maintain records of all memorandum fund activity for inspection by the Commission, and (e) obtain the Commission's approval to include the infrastructure improvements in rate base as the improvements become necessary and useful.

3. SCWC is directed to remove relevant Charnock Basin assets from rate base in its current general rate case for the region, Application (A.) 03-10-006.

4. SCWC is directed to transfer net proceeds received from Potentially Responsible Parties (PRPs) with respect to the Charnock Basin contamination from Account 704 (purchased water) to Account 704.02 (purchased water balancing account) for later refund to ratepayers of the excess shown in Account 704.02.

5. SCWC is directed to book future net proceeds to be received from PRPs with respect to the Charnock Basin contamination to Account 704.02 for later refund to ratepayers of the excess shown in Account 704.02.

6. A.02-07-021 is closed.

This order is effective today.

Dated _____, at San Francisco, California.